Working Capital

Working Capital (WC) is essential for any firm to operate and function on a daily basis: Only proper WC management ensures that raw material purchased, staff salaries and wages or even utility bills can be paid on time. To achieve this, an important part of WC management is about speedy collection of receivables and inventory turnover.

WC comprises components on both, the active and the passive side of a firm´s balance sheet: In Corporate Finance terms, WC is in principle composed of a firm´s cash, cash equivalents, receivables and inventory, as well as its payables. Therefore, WC combines most positions of a firm´s current assets as well as current liabilities: However, short-term debt (i.e. short-term interest bearing liabilities), for example, would not be included in WC. – When talking about WC, frequently analysts and investors actually refer to net working capital, defined as WC assets minus WC liabilities.

To assess whether a firm´s WC is used efficiently, one may determine for how long each of its components is held, or: how often it is turned over. This approach is useful, as nowadays firms tend to keep net working capital low (at times, if feasible, even negative), as a net-positive position must eventually be funded.

For example, the collection period of a firm indicates how fast customers pay for goods delivered or services provided: Thereby, the firm´s revenues reflect goods and services already delivered, whilst its receivables represent the amount customers are still required to pay. To calculate the collection period (i.e. the number of days outstanding), one may simply divide the receivables by the daily revenues of the firm. – Logically, the faster a firm collects cash from its customers, the better, and the sooner this cash can be re-employed for other purposes. There is also another advantage, though: The faster outstanding payments are collected, the lesser funding is required. - Of course, number of days outstanding also depends on the industry a firm is operating in as well as its bargaining power vis-à-vis its customers. Whilst a supermarket chain typically benefits from a very short collection period (just hours, even minutes, as customers frequently pay in cash at the till), such may stretch over many months in industries delivering complex industrial products.

On the other hand, if a firm can afford it, then it may decide paying its suppliers as late as possible. – In a Corporate Finance context, late payments can be interpreted that suppliers actually provide credit to the firm, with the additional benefit that payables do not bear any interest either. In consequence, pursuing such strategy would reduce a firm´s funding requirements by means of (interest bearing) debt from its commercial lenders. – Of course, also payment periods depend on the industry one is operating in and the bargaining power vis-à-vis suppliers. – The days payable – or a firm´s payment period - is commonly defined by dividing a firm´s payables by its cost of goods sold per day. Whilst this may not be the most accurate approach, the underlying assumption is that most payables are linked to goods and services provided to a firm, which will then be further processed in its operations.

Finally, firms holding comparably smaller amounts of inventory are considered more efficient: This would indicate an inventory turned over faster, whereby – again -, less funding would be required. Lean production, among others aggressively pursued in the automotive industry since the 1980s (lean management), has since also shown its downsides, though: Even minor, temporary disruptions in the supply chain can have disastrous consequences for entire production processes. - The approximate number of days a firm´s inventory is bound can be calculated by dividing the inventory position by the cost of goods sold per day. As before, this calculation approach assumes that most of the raw material, semi-finished and finished goods – together forming the inventory - will be further processed within the firm´s operations.

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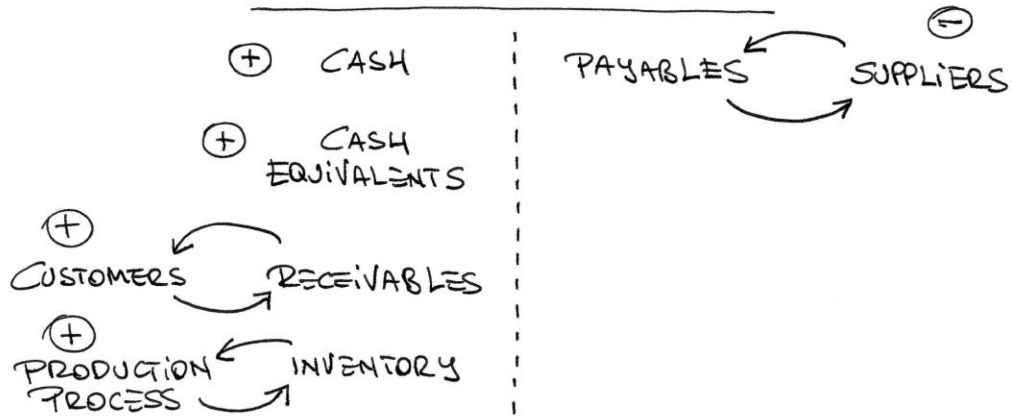
BALANCE SHEET



(+) BINDS WORKING CAPITAL
= INCREASES FUNDING REQUIREMENTS

(–) RELEASES WORKING CAPITAL
= REDUCES FUNDING REQUIREMENTS

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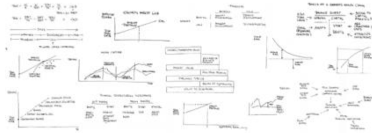

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